Report

of the

Examination of

Hawkeye-Security Insurance Company

Pewaukee, Wisconsin

As of December 31, 2001

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State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

Jim Doyle, *Governor*
Jorge Gomez, *Commissioner*

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December 31, 2001

Honorable Sally McCarty
Secretary, Midwestern Zone III, NAIC
Commissioner of Insurance
State of Indiana
311 West Washington Street, Suite 300
Indianapolis, IN 46204-2787

Honorable Jorge Gomez
Commissioner of Insurance
State of Wisconsin
125 South Webster Street
Madison, WI 53702

Commissioner:

In accordance with your instructions, a compliance examination has been made of the affairs and financial condition of:

HAWKEYE-SECURITY INSURANCE COMPANY
PEWAUKEE, WISCONSIN

and this report is respectfully submitted.

I. INTRODUCTION

The previous examination of the company was conducted in 2001, as of December 31, 2000. The current examination covered the intervening period ending December 31, 2001, and included a review of such 2002 transactions as deemed necessary to complete the examination.

The examination consisted of a review of all major phases of the company's operations, and included the following areas:

History
Management and Control
Corporate Records
Conflict of Interest
Fidelity Bonds and Other Insurance
Employees' Welfare and Pension Plans
Territory and Plan of Operations
Affiliated Companies

Growth of Company
Reinsurance
Financial Statements
Accounts and Records
Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comments on the remaining areas of the company's operations are contained in the examination work papers.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

II. HISTORY AND PLAN OF OPERATION

Hawkeye-Security Insurance Company (f.k.a., Tower Insurance Company, Incorporated, "Tower") which is hereinafter known as "Hawkeye-Security" or the "company" was organized in 1960, as Tower Fire and Casualty, Inc. Tower Fire and Casualty, Inc., was organized as a subsidiary of Catholic Knights Insurance Society, a Wisconsin-domiciled fraternal benefit society, to offer property and casualty products to its membership. The company changed its name to Tower Insurance Company, Inc., on January 3, 1961.

In May 1972, a controlling interest in Tower was purchased by Fiduciaries, Inc., a publicly held holding company. During the period between December 15, 1978, and March 5, 1979, through a complex series of mergers and corporate reorganizations, Tower and its parent Fiduciaries, Inc., were merged into a newly created Wisconsin insurer, Custodian Insurance Company, Inc., with the latter company surviving.

Custodian Insurance Company, Inc., an indirect wholly owned subsidiary of Guardian Royal Exchange, PLC, was incorporated on February 23, 1979. It commenced business on March 5, 1979, effective with the final merger transaction with Tower. This final merger transaction dissolved the existence of the original Tower as an independent entity and cancelled all of its issued and outstanding common stock. The surviving Custodian Insurance Company, Inc. changed its name to Tower Insurance Company, Inc., concurrent to the final merger transaction. In this way, Tower became an indirect wholly owned subsidiary of Guardian Royal Exchange, PLC, (GRE).

On April 18, 1996, Atlas Assurance Company of America (Atlas), a New York domiciled company in the GRE holding company system, received permission to acquire control of Tower. GRE sold its United States operations, including Tower, to Liberty Mutual Insurance Company (LMIC) on April 29, 1999. The current holding company structure is located in the Affiliated Company section of this report. On March 4, 2002, Tower changed its name to Hawkeye-Security Insurance Company.

In 2001, the company wrote direct premium in the following states:

Illinois	$(19,440)	13.8%
Iowa	(34,065)	24.2
Minnesota	(10,908)	7.7
Nebraska	(3,650)	2.6
Wisconsin	(72,960)	51.7
	$(141,023)	100%

The company is also licensed in the following states, but had no direct premium: Colorado, Indiana, Kansas, Michigan, Missouri, Montana, North Dakota, and South Dakota.

The company, under its old name (Tower), had stopped writing new business in 1999 and is moving renewals to other affiliates, as permitted. On October 30, 2001, LMIC entered into a partnership agreement with One Beacon Corporation under which companies of LMIC's Regional Agency Markets strategic business unit would assume much of the property and casualty business written through the OneBeacon underwriting companies in 42 states. As part of this agreement, a portion of the former OneBeacon direct business will be assumed and rewritten through Hawkeye-Security in the states of Minnesota, Wisconsin, Missouri, Iowa, North Dakota, South Dakota, Nebraska, and Kansas, subject to the company's underwriting standards and individual state laws and regulations. Liberty Mutual Insurance Company also acquired the rights to the Hawkeye-Security name.

The company reported negative direct premium written in 2001. However, the company reported no net premiums written as a result from the negative direct premium written of $(141,023) less reinsurance premiums ceded to affiliates of $6,530 and the reinsurance premiums ceded to non-affiliates of $(147,553). The company's in-force business is ceded under a 100% quota share reinsurance contract to its parent, Atlas.

The company began writing new business under its current name in the second quarter of 2002. The company's major products for 2002 include Private Passenger Auto Liability, Auto Physical Damage, Homeowners Multiple Peril, and Commercial Multiple Peril.

2001 Premium Written

Line of Business	Direct Premium	Reinsurance Assumed	Reinsurance Ceded	Net Premium
Homeowners multiple peril	$ (807)		$ (807)	$0
Commercial multiple peril	(17,986)		(17,986)	
Inland marine	(132)		(132)	
Workers' compensation	(110,090)		(110,090)	
Other liability - occurrence	(11,322)		(11,322)	
Private passenger auto liability	(278)		(278)	
Commercial auto liability	(93)		(93)	
Auto physical damage	(315)		(315)	
		-		
Total All Lines	$(141,203)		$(141,203)	$0

2002 Premium Written

Line of Business	Direct Premium	Reinsurance Assumed	Reinsurance Ceded	Net Premium
Fire	$ 55,000	$ 0	$ 55,000	$0
Allied Lines	48,405		48,405	
Homeowners Multiple Peril	1,346,824		1,346,824	
Commercial Multiple Peril	1,000,413		1,000,413	
Inland Marine	148,669		148,669	
Earthquake	16,427		16,427	
Workers' Compensation	878,102		878,102	
Other Liability – Occurrence	521,438		521,438	
Products Liability – Occurrence	18,436		18,436	
Private Passenger Auto Liability	1,878,195		1,878,195	
Commercial Auto Liability	376,432	27,011	403,443	
Auto Physical Damage	1,826,201	(162,347)	1,663,854	
Burglary and Theft	307		307	
Total All Lines	$8,114,849	$(135,336)	$7,979,513	$0

III. MANAGEMENT AND CONTROL

Board of Directors

The board of directors consists of 11 members. All directors are elected annually to serve a one-year term. Officers are elected at the board's annual meeting. Members of the company's board of directors may also be members of other boards of directors in the holding company group. The board members currently receive no compensation for serving on the board.

As of year-end 2001, the board of directors consisted of the following persons, seven of whom were re-elected in 2003:

Name and Residence	Principal Occupation	Term Expires
Richard T. Bell Loveland, OH	President & CEO Consolidated Insurance Co., Indiana Ins. Co; Mid-American Fire & Casualty, and The Midwestern Indemnity Co.	2002
J. Paul Condrin III Walpole, MA	Senior Vice-President & Chief Financial Officer, Liberty Mutual Insurance Company.	2002
Honore J. Fallon Belmont, MA	Vice-President and Assistant General Counsel, Liberty Mutual Insurance Company. Senior Vice President, Liberty RAM.	2002
Anthony A. Fontanes Hingham, MA	Senior Vice-President and Chief Investment Officer, Liberty Mutual Insurance Company.	2002
Roger L. Jean Amherst, NH	Executive Vice-President, Liberty Mutual Insurance Company. President Liberty RAM.	2002
Forrest H. Johnson Bristol, VA	Senior Vice-President, Claims; Chief Claims Officer, Liberty Mutual Insurance Company.	2002
Bertrand J. La Chance West Chesterfield, NH	Actuary, Tower Insurance Company; Vice-President, The Netherlands Ins. Co.	2002
Dennis J. Langwell Franklin, MA	Vice-President and Comptroller, Corporate Finance, Liberty Mutual Insurance Co.	2002
Jane F. Taylor Keene, NH	Vice-President, Secretary and General Counsel, The Netherlands Insurance Co.	2002

The company elected the following new officers and directors as of June 1, 2003.

Name and Residence	Principal Occupation	Term Expires
Dwight W. Bowie Des Moines, IA	President & CEO	2004
* Mark E. Fiebrink Amherst, NH	Executive Vice President and Assistant Treasurer	2004
Alexander A. Fontanes Hingham, MA	Executive Vice President and Chief Investment Officer	2004
* Forrest H. Johnson Bristol, VA	Senior Vice President	2004
* Amy J. Leddy Weston, MA	Senior Vice President	2004
* William G. Mersch Groton, MA	Senior Vice President	2004
Thomas G. Moylan Somerville, MA (Resigned 7-18-03)	Senior Vice President and Chief Actuary	2004
* Charles B. Ruzicka Mason, OH	Senior Vice President	2004
Bill R. Breckenridge Clive, IA	Vice President – Commercial Underwriting	2004
John D. Hanna Clive, IA	Regional Vice President	2004
Douglas T. Jenkins Cincinnati, OH	Vice President, Secretary and General Counsel	2004
Beth Clare Kreidenweis Springfield, OH	Vice President – Corporate Services	2004
Aaron Larson Ankeny, IA	Vice President – Actuarial	2004
Patrick Murphy Norwalk, IA	Vice President – Claims	2004
Lawrence J. Olenchek Waukesha, WI	Regional Vice President	2004
* Gary J. Ostrow Sharon, MA	Vice President	2004
Susan M. Veeder Johnston, IA	Vice President and Company Controller	2004
Harold Ordean Voight, Jr. Urbandale, IA	Vice President – Marketing	2004

* Stephen D. Powell Keene, NH	Treasurer and Assistant Vice President	2004

- Indicates board members who were elected in 2003 and whose terms expire in 2004

- **Officers of the Company**

The officers serving at the time of this examination were as follows:

Name	Office	2001 Compensation
Richard T. Bell	President & Chief Executive Officer	$306,928.50
Honore J. Fallon	Vice-President and Assistant General Counsel	38,153.84
Mark E. Fiebrink	Exec. Vice-President & Chief Financial Officer	295,965.00
Forrest H. Johnson	Senior Vice-President Claims	187,314.75
Amy J. Leddy	Senior Vice-President	148,039.04
William G. Mersch	Senior Vice-President Human Resources	163,115.29
Stephen D. Powell	Treasurer and Assistant Vice-President	104,709.00
Charles B. Ruzicka	Senior Vice-President Information Technology	209,620.50
Jane F. Taylor	Vice-President, Secretary & General Counsel	128,662.50

The officers and directors serving in 2002 had the following compensation levels:

Name	Office	2002 Compensation
W Dwight Bowie	President	$327,575.34
Bill R. Breckenridge	Vice President Commercial – Underwriting	138,742.90
J. Paul Condrin III	Senior Vice President & C.F.O.	914,619.87
James Lee Dornfield	Vice President & Actuary	169,633.28
Honore Fallon	Vice President & Assistant General Counsel	363,672.24
Mark E. Fiebrink	Executive Vice President and Treasurer	495,766.45
Alexander Fontanes	Chief Investment Officer	2,020,469.01
Philip J. Guymont	Senior Vice President & C.F.O.	226,075.92
John Hanna	Regional Vice President	50,057.65
Roger Jean	President Liberty Ram	1,102,279.22
Douglas T. Jenkins	Vice President, Secretary & General Counsel	136,891.48
Forrest H. Johnson	Senior Vice President	390,605.32
Beth Clare Kreidenweis,	Vice President Corporate Services	154,422.25
Dennis Langwell	Comptroller, Corporate Finance	409,878.06
Amy J. Leddy	Senior Vice President	228,956.09
Christopher Mansfield	General Counsel	823,935.71
William G. Mersch	Senior Vice President	226,167.88
Thomas G. Moylan	Senior Vice President & Chief Actuary	217,889.51
Patrick Murphy,	Vice President – Field Claims Operations	118,777.82
Lawrence J. Olenchek	Regional Vice President	104,857.95
Gary Ostrow	Director – Corporate Taxation	371,194.50
Stephen D. Powell	Treasurer and Assistant Vice President	141,546.59
Charles B. Ruzicka	Senior Vice President	316,909.42
Susan M. Veeder	Vice President and Company Controller	103,183.80
Ordean Harold Voight, Jr.	Vice President – Marketing	8,447.37

The above figures reflect the total compensation paid to the company’s officers for their service to Hawkeye-Security and the Liberty Mutual group. Any salary allocation to Hawkeye-Security is transferred to Atlas under the 100% quota share reinsurance agreement.

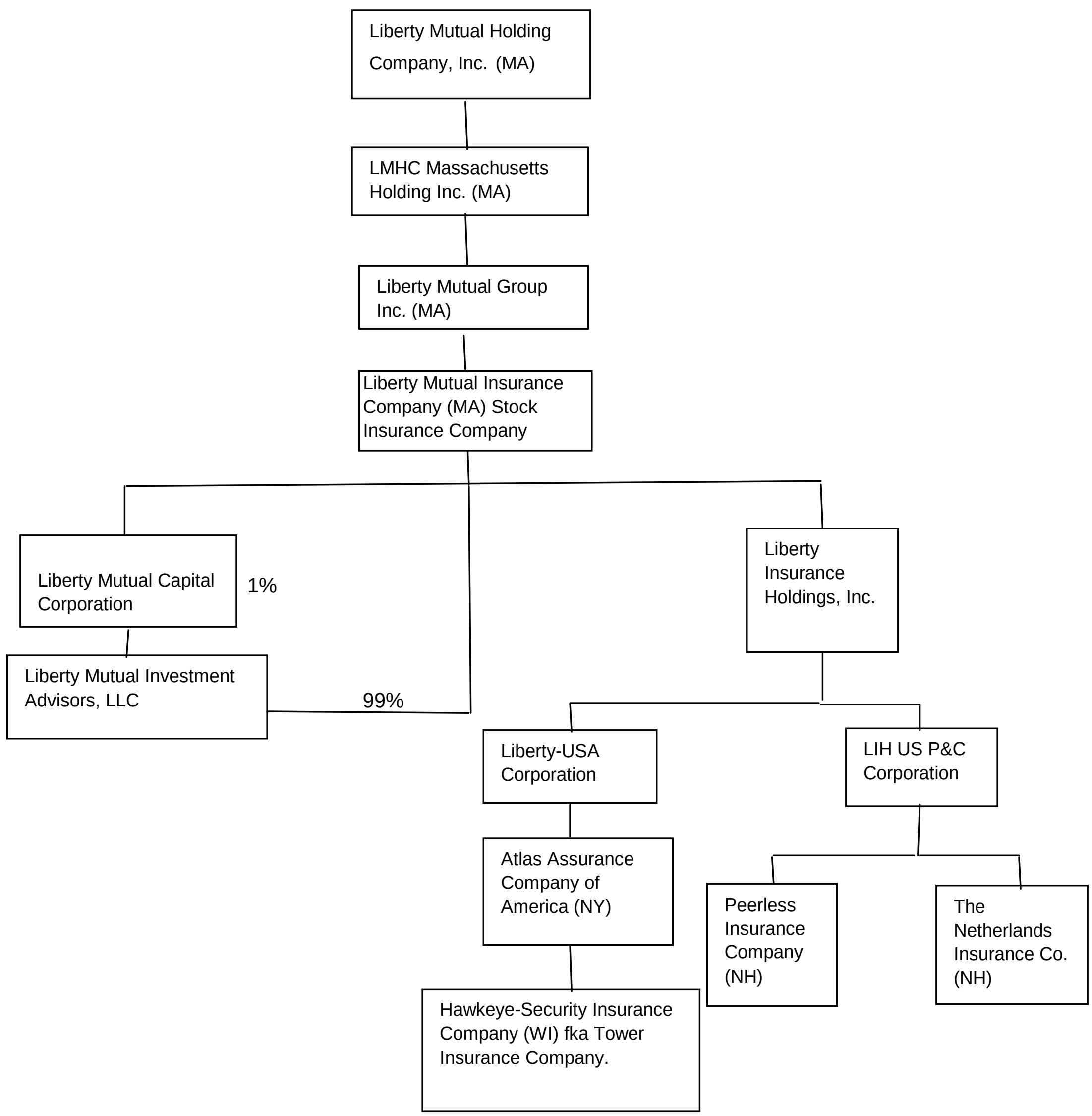
Committees of the Board

The company's bylaws allow for the formation of certain committees by the board of directors. There were no committees at the time of the examination.

IV. AFFILIATED COMPANIES

Hawkeye-Security is a member of a holding company system. The organizational chart below depicts the relationships among the affiliates in the group as of the examination date and that were deemed important to Hawkeye-Security's operations. A brief description of the significant affiliates of Hawkeye-Security follows the chart.

Organizational Chart
As of December 31, 2001



Liberty Mutual Group Inc.

Liberty Mutual Group Inc., is a diversified worldwide insurance service organization that employs 36,000 people in more than 800 offices around the world. Liberty Mutual Group is one of the largest multi-line insurers in the North American property/casualty industry. The Liberty Mutual Group, Inc., has been a leading provider of workers' compensation insurance, programs and services for nearly 65 years.

As of December 31, 2001, the company's audited financial statement showed assets of $29,857,611,556, liabilities of $24,077,391,531, and unassigned funds and special reserves of $5,780,220,025. Operations for 2001 produced a net loss of ($288,722,400).

Liberty Mutual Insurance Company (LMIC)

LMIC is the ultimate insurance company parent of Hawkeye-Security and the owner of a large diversified holding company system whose products and services include property and casualty, health, and life insurance, and investment and management services. In 2000, Liberty Mutual Insurance Company filed an application to restructure under a mutual holding company plan pursuant to the laws of the Commonwealth of Massachusetts. The laws both of Massachusetts and Wisconsin allow a mutual insurance company to convert to a stock insurance company by placing the mutual policyholders' ownership rights in a mutual holding company, which then becomes the owner of the newly-converted stock insurance company.

On November 9, 2001, Liberty Mutual's policyholders approved the reorganization of their company into a mutual holding company structure, and on November 27, 2001, the Massachusetts' Commissioner of Insurance approved the reorganization. On November 28, 2001, Liberty Mutual became a stock corporation under the control of Liberty Mutual Holding Company Inc., which contributed all of the issued and outstanding common shares of Liberty Mutual to LMHC Massachusetts Holdings Inc., which, in turn contributed this stock to Liberty Mutual Group Inc.

On March 14, 2002, the members of Liberty Mutual Holding Company, Inc., voted to approve a merger of Employers Insurance of Wausau Mutual Holding Company with and into Liberty Mutual Holding Company, Inc. This merger was consummated on March 19, 2002.

LMIC has an agreement to manage and invest the company's investment portfolio and a tax sharing agreement with the company. As of December 31, 2001, the company's audited financial statement reported assets of $19,151,797,502, liabilities of $14,675,590,384, and unassigned funds and special reserves of $4,476,207,118. Operations for 2001 produced a net loss of ($312,906,684).

Liberty Insurance Holdings, Inc. (LIHI)

LIHI is a holding company, domiciled in Delaware, and wholly owned by LMIC. It is engaged primarily in insurance activities through its subsidiaries. The company is part of the Liberty Insurance Holdings, Inc. (LIH) group reinsurance and pooling agreement. The group participants cede substantially all of their direct and assumed business to the lead company, Peerless Insurance Company, the company's parent as of December 31, 2002. The LIH pool participants are listed below along with the pool percentages for 2002 and 2001:

Peerless Insurance Company	41.59%
Indiana Insurance Company	27.78%
Atlas Assurance Company of America	27.36%
The Netherlands Insurance Company	3.27%

As of December 31, 2001, the company's audited financial statement reported assets of $1,002,027,658, liabilities of $6,869,158, and stockholder's equity of $995,158,500. Operations for 2001 produced net income of $37,019.

Liberty-USA Corporation (LUSAC)

LUSAC is a holding company, domiciled in Delaware, and wholly owned by (LIHI). It is engaged primarily in insurance activities through its subsidiaries. As of December 31, 2001, the company's unaudited financial statement reported assets of $507,080,559, liabilities of $1,241,460, and stockholder's equity of $505,839,099. Operations for 2001 produced net income of $2,131,631.

Atlas Assurance Company of America (Atlas)

Atlas provides property and casualty insurance and is wholly owned by LUSAC. As of December 31, 2001, the company's audited financial statement reported assets of $1,026,243,051, liabilities of $631,814,448, and unassigned funds and special reserves of $394,428,603. Operations for 2001 produced net income of $10,685,838.

Hawkeye-Security has a 100% quota share reinsurance contract with Atlas. All business written or assumed by Hawkeye-Security is ceded to Atlas through this contract. More detailed information on the contract terms is located in the "Reinsurance Section" of this report.

On December 31, 2002, Atlas Assurance Company of America merged with and into Peerless Indemnity Insurance Company, whereby, Peerless Insurance Company became owner of 100% of the stock of Hawkeye-Security. Peerless Indemnity is an Illinois-domiciled company that is wholly owned by Liberty-USA Corporation.

Peerless Insurance Company (PIC)

PIC is a property and casualty company domiciled in New York. PIC has no employees of its own. The company is a participating member of the quota share reinsurance agreement in which the company and four other subsidiaries cede all of their net underwriting results to Peerless Indemnity Insurance Company. The participants in this agreement are as follows:

The Midwestern Indemnity Company
Mid-American Fire & Casualty Company
Globe American Casualty Company
American Ambassador Casualty Company
Hawkeye-Security Insurance Company

As of December 31, 2001, the company's audited financial statement reported assets of $1,214,992,973, liabilities of $984,419,540, and unassigned funds and special reserves of $230,573,433. Operations for 2001 produced a net loss of ($9,369,067).

Liberty Mutual Investment Advisors, LLC (LMIA)

LMIA is a Massachusetts limited liability corporation that is an indirect subsidiary of LMIC (99% owned by LMIC and 1% owned by Liberty Mutual Capital Corporation). LMIA provides cash management services to companies within the LMIC holding company structure, including Hawkeye-Security. As of December 31, 2001, the company's financial statement reported no net assets or liabilities and operations for 2001 produced no net income or loss.

Service Agreements with Affiliate

Hawkeye-Security has no employees of its own. The company has a services agreement with Peerless Insurance Company. PIC has an agreement with another affiliate, The Netherlands Insurance Company (TNIC) for employees. PIC utilizes the employees of TNIC to provide the services to Hawkeye-Security. The services provided to both the company and PIC include: a) executive management; b) accounting, tax reporting and treasury management; c) human resource; d) administration; e) communications; f) marketing; g) planning and budgeting; h) legal; i) investment; j) home office insurance coverage; k) actuarial; l) internal audit; m) information technology; n) corporate purchasing; o) central processing; p) underwriting support, and q) claims support.

Tax Sharing Agreement

On January 1, 2002, the company joined Liberty Mutual Holding Company (LMHC) in a new tax sharing agreement. This agreement replaced the prior years tax sharing agreement. LMHC will file a tax return on behalf of the Registrants and other qualified subsidiaries. On January 21, 2002, the company filed a consolidated audited financial statement with two of the Liberty Mutual Group Pools.

V. REINSURANCE

The company's reinsurance portfolio and strategy is described below. A list of the companies that have a significant amount of reinsurance in force at the time of the examination follows. The contract contained the proper insolvency provisions. In addition to the following quota share reinsurance contract with its affiliate, the company had two facultative certificates in force.

Affiliated Ceding Contracts

1.	Type:	100% Quota Share
	Reinsurer:	Atlas Assurance Company of America
	Scope:	All business written by the company
	Retention:	none
	Coverage:	all business written
	Premium:	100%
	Commissions:	Amount equal to the company’s underwriting expenses, plus Policyholders’ dividends and agents’ balances charged-off less Finance and service charges not included in premium.
	Effective date:	October 1, 1999
	Termination:	90 days prior written notice

VI. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported in the December 31, 2001, annual statement to the Commissioner of Insurance. Also included in this section are schedules that reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Surplus per Examination."

Hawkeye-Security Insurance Company
Assets
As of December 31, 2001

	Assets	Nonadmitted Assets	Net Admitted Assets
Bonds	$30,106,382	$	$30,106,382
Cash	(581,556)		(581,556)
Short-term investments	1,339,441		1,339,441
Reinsurance recoverable on loss and loss adjustment expense payments	845,736		845,736
Federal and foreign income tax recoverable and interest thereon	724,800	154,686	570,114
Electronic data processing equipment and software	17,745		17,745
Interest, dividends, and real estate income due and accrued	475,515		475,515
Equities and deposits in pools and associations	(3,101)		(3,101)
Other assets nonadmitted:			
Furniture, equipment, and supplies	149,580	149,580	
Leasehold improvements	144,062	144,062	
Total Assets	$33,218,604	$448,328	$32,770,276

Hawkeye-Security Insurance Co.
Liabilities, Surplus, and Other Funds
As of December 31, 2001

Federal and foreign income taxes	$ 318,810
Provision for reinsurance	300,467
Payable to parent, subsidiaries, and affiliates	2,896,934
Write-ins for liabilities:	
Reserve for unpresented checks	187,745
Total Liabilities	3,703,956
Common capital stock	2,000,000
Preferred capital stock	7,784,101
Unassigned funds (surplus)	19,282,219
Surplus as Regards Policyholders	29,066,320
Total Liabilities and Surplus	$32,770,276

Hawkeye-Security Insurance Company
Summary of Operations
For the Year 2001

Investment Income	
Net investment income earned	$1,926,977
Net realized capital gains or (losses)	190,454
Net investment gain or (loss)	2,117,431
Other Income	
Write-ins for miscellaneous income:	3,103
Net income (loss) before dividends to policyholders and before federal and foreign income taxes	2,120,534
Net income (loss) after dividends to policyholders but before federal and foreign income taxes	2,120,534
Federal and foreign income taxes incurred	(537,273)
Net Income	$2,657,807

Hawkeye-Security Insurance Company
Cash Flow
As of December 31, 2001

Loss and loss adjustment expenses paid (net of salvage or subrogation)	$ (5,744)		
Cash from underwriting		$ 5,744	
Net investment income		2,022,681	
Other income (expenses):			
Write-ins for miscellaneous items:			
Equities and deposits in pools and associations	(525,565)		
Total other income		(525,565)	
Net cash from operations			$1,502,860
Proceeds from investments sold, matured, or repaid:			
Bonds	7,872,232		
Total investment proceeds		7,872,232	
Cost of investments acquired (long-term only)			
Bonds	15,080,071		
Total investments acquired		15,080,071	
Net cash from investments			(7,207,839)
Cash provided from financing and miscellaneous sources:			
Net transfers from affiliates	2,766,358		
Other cash provided	263,385		
Total		3,029,743	
Net cash from financing and miscellaneous sources			3,029,743
Net change in cash and short-term investments			(2,675,236)
Reconciliation			
Cash and short-term investments, December 31, 2000			3,433,121
Cash and short-term investments, December 31, 2001			$ 757,885

Hawkeye-Security Insurance Company
Compulsory and Security Surplus Calculation
December 31, 2001

Assets		$32,770,276
Less liabilities		3,703,956
Adjusted surplus		29,066,320
Annual premium:		
Lines other than accident and health	$(141,023)	
Factor	20%	
Compulsory surplus (subject to a minimum of $2 million)		2,000,000
Compulsory surplus excess (or deficit)		$27,066,320
Adjusted surplus (from above)		$29,066,320
Security surplus: (140% of compulsory surplus, factor reduced 1% for each $33 million in premium written in excess of $10 million, with a minimum factor of 110%)		2,800,000
Security surplus excess (or deficit)		$26,266,320

Hawkeye-Security Insurance Company
Reconciliation and Analysis of Surplus
For the Five-Year Period Ending December 31, 2001

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

	1997	1998	1999	2000	2001
Surplus, beginning of year	$25,575,395	$23,958,391	$24,356,542	$24,653,158	$25,772,677
Net income	(1,240,336)	(113,357)	(56,819)	984,760	2,657,807
Net unrealized capital gains or (losses)	342,409	(82,552)	(5,779,226)		
Change in deferred income tax					29,063
Change in non-admitted assets	303,100	(466,244)	211,122	66,899	593,244
Change in provision for reinsurance		(294,000)	(45,327)	67,860	
Change in foreign exchange adjustment	(71,677)	5,697	(32,134)		
Change in excess statutory reserves over statement reserves	(950,500)	1,785,500	5,999,000		
Cumulative effect of changes in accounting principles					13,529
Surplus, end of year	$23,958,391	$24,36,542	$24,653,158	$25,772,677	$29,066,320

Hawkeye-Security Insurance Company
Insurance Regulatory Information System
For the Five-Year Period Ending December 31, 2001

The following is a summary of NAIC Insurance Regulatory Information System (IRIS) results for the period under examination. Exceptional ratios are denoted with asterisks. A discussion of the exceptional ratios may be found after the IRIS ratios.

	Ratio	1997	1998	1999	2000	2001
#1	Gross Premium to Surplus	263%	266%	134%	4%	0%
#2	Net Premium to Surplus	255	259	36	0	0
#3	Change in Net Writings	6	5	-86*	-99*	0
#4	Surplus Aid to Surplus	0	0	0	0	0
#5	Two-Year Overall Operating Ratio	104*	106*	123*	222*	0
#6	Investment Yield	5.5	5.4	9.1	6.7	6.9
#7	Change in Surplus	-2	5	-28*	5	13
#8	Liabilities to Liquid Assets	82	82	3	4	12
#9	Agents' Balances to Surplus	19	15	0	0	0
#10	One-Year Reserve Devel. To Surplus	15	-24	0	9	0
#11	Two-Year Reserve Devel. To Surplus	20*	12	0	0	0
#12	Estimated Current Reserve Def. To Surplus	-4	-24	-121*	0	0

Ratio No. 3 measures the company's change in net premium written. In 1999 and 2000, the exceptional results of -86% and -99% was the result of the company entering into a 100%

quota share reinsurance contract with Atlas Assurance Company of America in October 1999 and the significant decrease in the company's direct business. Ratio No. 5 measures the company's profitability over the previous two-year period. The exceptional results from 1997 through September 1999 are the result of the company's decline in retained business. The 2000 exceptional result was due to the net change in writings as the company began, on October 1, 1999, ceding 100% of its business to an affiliate. In 1997, the company experienced adverse loss experience due to severe storms resulting in reserve strengthening. Ratio No. 7 shows the change in surplus from year to year. The 1999 exceptional result was due to the 100% quota share reinsurance contract mentioned above. Ratio No. 11 compares the reserve development to surplus over a two-year period. The ratio was exceptional in 1997 as a result of the company's strengthening of its reserves in 1997. Ratio No. 12 compares the reserve development to surplus and includes a factor for premium volume. The exceptional result in 1999 was due to the 100% quota share reinsurance contract with Atlas.

Growth of Hawkeye-Security Insurance Company

Year	Admitted Assets	Liabilities	Surplus As Regards Policyholders	Net Income
1997	$106,996,380	$83,037,989	$23,958,391	$(1,240,336)
1998	112,745,968	88,389,426	24,356,542	(113,357)
1999	25,344,579	691,421	24,653,158	(56,819)
2000	27,063,144	1,290,467	25,772,677	984,760
2001	32,770,276	3,703,956	29,066,320	2,657,807

Year	Gross Premium Written	Net Premium Written	Premium Earned	Loss And LAE Ratio	Expense Ratio	Combined Ratio
1997	$62,891,999	$61,110,310	$59,608,109	81.3%	31.7%	113%
1998	66,015,794	64,261,498	62,515,369	75.5	33.2	108.7
1999	33,081,997	8,965,930	44,039,090	93.9	140.5	234.4
2000	942,801	0	0	0	0	0
2001	(141,203)	0	0	0	0	0

As previously mentioned, effective October 1, 1999, Hawkeye-Security began ceding 100% of its business to an affiliate. The notable changes in the company results for 1999 and 2000 largely relate to these changes in reinsurance.

Reconciliation of Surplus per Examination

There were no adjustments to members' surplus as determined by this examination.

Examination Reclassifications

	Debit	Credit
Affiliated Balances	$2,896,934	
Accounts Receivable – Liberty RAM	$19,843,399	
Accounts Payable – P&C Fronting Co.		22,740,333
Total reclassifications	$22,740,333	$22,740,333

VII. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

There were two specific comments and recommendations in the previous examination report. Comments and recommendations contained in the previous examination report and actions taken by the company are as follows:

1. Invested Assets - Cash—It is recommended that the company properly classify all affiliated balances in future annual statements.

   Action — Non-compliance. Please refer to the "Summary of Current Examination Results" section of this report.

2. Holding Company – It is recommended that the company file an accurate organizational chart according to the NAIC Annual Statement Instructions – Property and Casualty.

   Action — Non-compliance. Please refer to the "Summary of Current Examination Results" section of this report.

Summary of Current Examination Results

Cash

The company, as of December 31, 2001, was still carrying an amount equal to the checks issued by an affiliate (Peerless Insurance Company) on behalf of the company of ($691,760.78). A review of the 2002 Annual statement's Schedule E, Part 1, shows the company has since corrected this prior examination recommendation.

Organizational Chart

It was also noted that the company, on its December 31, 2001 organizational chart, had not listed Liberty Mutual Investment Advisors, LLC as part of its holding company group. A review of the 2002 annual statement's organizational chart showed the company has since corrected this prior examination recommendation.

Control Environment

The examiners noted control environment weaknesses found in the New Hampshire Insurance Department's (NHID) work within the Liberty Holdings Group. The examiners relied on the NHID to perform testing of certain cash, reinsurance and intercompany accounts due to Hawkeye-Security. It was noted by the examiners and also confirmed by the NHID, that the company's main cash account (Wachovia Bank) is under the control of Peerless Insurance Company. Peerless Insurance Company, who is under examination by the New Hampshire Insurance Department, also administers the intercompany balances among pooled members. NHID noted the following control weaknesses.

1) The legal entity and operating entity reporting basis requires several reclassifications of transaction entries. This process requires multiple levels of reconciliation. The structure of these entries impeded the identification of supporting transaction detail.
2) The reinsurance systems have been retrofitted to the companies' production system as the production systems are acquired or integrated. This multi-platform system results in a difficult integration and application of controls. The lack of controls has had a significant impact on the ability to perform accurate and timely reconciliations of the reinsurance accounts and to identify source transaction documentation.

3) Periodic interim fund transfers are made to settle intercompany accounts based on the net balances at the time of transfer. The intercompany account settlement process does not allow for the identification of balances being settled.

It is recommended that the company institute adequate controls and allocate sufficient resources to ensure that the reinsurance and intercompany accounts be accurately reported and also be supported by identifiable detail transaction documentation.

Reinsurance Recoverable

The examiners had the company complete a control questionnaire on its reinsurance recoverables for the year ending December 31, 2001. It was noted by the company that due to staff turnover, reinsurance recoverables were not billed or rebilled until June of 2003. As a result, the company was unable to provide documentation of subsequent year settlements for the ceded reinsurance loss recoverables. It is recommended that the company bill and properly settle all reinsurance recoverables on a timely basis.

Federal Income Tax Recoverable

During the examination it was discovered that the company was unable to provide documentation to substantiate the federal income tax accrual reported December 31, 2001. The examiners calculated the federal income tax accrual balance based on information obtained from the CPA, which may not take in consideration any prior year tax provisions the company may have used. The accrual balance calculated by the examiner exceeded the balance reported by the company by an immaterial amount. Given the noted results, no adjustment to surplus was made. However, it is recommended that the company retain all supportive tax documentation and provide a reconciliation to substantiate the year-end accrual for its federal income taxes.

Affiliated Balances

During the examination it was discovered that the company had netted the sum of its affiliated transactions within the detailed general ledger report provided to the examiners. The affiliated payable balance reported on the annual statement of $2,896,934 is comprised of the net amount owed to Property and Casualty Fronting Company of $22,740,333, and the net amount due from Liberty Regional Agency Markets of $19,843,399. The NAIC Accounting Practices and Procedures Manual SSAP No. 64 establishes the statutory standards for offsetting and netting of assets and liabilities. The review of company documentation indicated that the company does not have a right of offset with the aforementioned entities. A reclassification of the reporting errors noted above can be found in the “Reconciliation of Surplus per Examination” section of this report. It is recommended that amounts due to and due from affiliates be offset and reported net only when the provisions of SSAP No. 64 are met.

Loss Reserves

The company, as of December 31, 2001, was carrying a net loss and loss adjusting expense reserve balance of $0. The examiners discovered that on December 21, 2000, a $3,500,000 jury verdict was rendered against Hawkeye-Security in a Wisconsin Court regarding a “bad-faith” case.

In a letter submitted by the company to this office in 2001, the company established a reserve of $750,000, representing the “bad-faith” court ruling against the company. The examiner discussed the $3,500,000 jury verdict rendered against the company with representatives of the company’s corporate legal division. The company, in 2003 established a reserve of $3,500,000 with the net impact on reserves, net of reinsurance, of $358,000. As a result of the adjustment made to reserves in 2003, no adjustment was made to surplus. However, it is recommended that the company properly include all contingency claims in its loss reserves on all future annual statements.

VIII. CONCLUSION

Policyholders' surplus has shown an increase from $25,277,677 as of year end 2000, to $29,066,320 as of year end 2001 as determined by this examination. This represents an increase of 12.78% during the period of examination.

The company is a participating member of a quota share reinsurance agreement in which the company and four other subsidiaries cede all of their net underwriting results to Peerless Indemnity Insurance Company. The participants in this agreement are:

The Midwestern Indemnity Company
Mid-American Fire & Casualty Company
Globe American Casualty Company
American Ambassador Casualty Company
Hawkeye-Security Insurance Company

The company had two prior examination recommendations, see "Summary of Current Examination Results" under the subtitles "Cash" and "Organizational Chart", which were satisfied subsequent to the current examination date of 2001.

Areas of improvement recommended by this examination included, but were not limited to, the control environment, reinsurance recoverables, taxes, affiliated balances, and loss reserves.

The company officially changed its name from Tower Insurance Company, Inc., to Hawkeye-Security Insurance Company, Inc., on March 4, 2002.

On December 31, 2002, Atlas Assurance Company of America merged with and into Peerless Indemnity Insurance Company, whereby Peerless Indemnity Insurance Company became owner of 100% of the stock of Hawkeye-Security Insurance Company. Peerless Indemnity is an Illinois domiciled company that is wholly owned by Liberty-USA Corporation.

On March 14, 2002, the members of Liberty Mutual Holding Company, Inc., voted to approve a merger of Employers Insurance of Wausau Mutual Holding Company with and into Liberty Mutual Holding Company, Inc. This merger was consummated on March 19, 2002.

IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 27 Control Environment - It is recommended that the company institute adequate controls and allocate sufficient resources to ensure that the reinsurance and intercompany accounts be accurately reported and also be supported by identifiable detail transaction documentation

2. Page 27 - Reinsurance Recoverables — It is recommended that the company properly bill and settle all reinsurance recoverables on a timely basis.

3. Page 27 - Taxes — It is recommended that the company retain all supportive tax documentation and provide a reconciliation to substantiate the year-end accrual for its federal income taxes.

4. Page 27- Affiliated Balances - It is recommended that amounts due to and due from affiliates be offset and reported net only when the provisions of SSAP No. 64 are met.

5. Page 28 Loss Reserves – It is recommended that the company properly include all contingency claims in its loss reserves on all future annual statements.

X. ACKNOWLEDGMENT

The courtesy and cooperation extended during the course of the examination by the officers and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Name	Title
John Litweiler	Financial Insurance Examiner

Respectfully submitted,

DuWayne Kottwitz
Examiner-in-Charge